529 Plan Distributions and Federal Tax Credits

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ABSTRACT

A common misperception among some financial service professionals is that an individual with a 529 plan who is paying for higher education costs should pay the first $4,000 of tuition and fees per year either out of a checking or savings account or out of a loan in order to take full advantage of the federal income tax credit or deduction and then pay the remainder out of the 529 plan. This article explains that the full amount of higher education costs can be paid out of a 529 plan and the maximum federal tax credit or deduction will still be received.

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Taxpayers can set up and contribute money into Qualified Tuition Programs, often called 529 plans for the Internal Revenue Code section that authorizes them. According to the Investment Company Institute, at the end of 2014, approximately $225 billion was invested in approximately 11 million 529 savings accounts. About two-thirds of the states in the United States offer income tax savings on such contributions. Each 529 account has one owner and one beneficiary, and having the same individual be both the owner and the beneficiary is allowed. Distributions from 529 accounts are tax free if used for tuition and required fees, books, supplies, and equipment of the beneficiary. Distributions for the beneficiary's room and board are also tax free for academic periods in which the student is enrolled at least half-time.

Separately, there is a federal tax credit for paying certain higher education expenses. This is the topic of a *Wall Street Journal* article that mistakenly stated that a federal tax credit cannot be claimed for higher education expenses covered by a 529 plan.[1] Such misperception is common, and the goal of this article is to correct it and explain how the federal income tax law actually works for qualified higher education expenses covered by 529 plan distributions.

Federal Tax Credits: American Opportunity and Lifetime Learning

Almost 20 years ago, federal tax credits began to

offset some of the costs of higher (i.e., postsecondary) education at a college, university, or vocational school eligible to participate in the U.S. Department of Education's Federal Student Aid program. Such tax credits are not available for higher education expenses paid by either the student's employer or scholarships the student receives.

Either the American Opportunity Credit (AOC) or the Lifetime Learning Credit (LLC) may be taken for higher education tuition and required fees (and, for the AOC only, required course materials) paid for the taxpayer, his or her spouse, and their dependents. Note that neither tax credit can be taken for the costs of room and board. For 2015, if the taxpayer files single or head of household, the AOC starts phasing out when adjusted gross income (AGI) exceeds $80,000, and disappears if AGI is $90,000 or above.[2] If the taxpayer is married and filing one joint income tax return, the AOC starts phasing out when AGI is above $160,000, and disappears if AGI is $180,000 or above. The way this phaseout works is that the further the taxpayer's AGI is into the phaseout range, the greater the reduction in the credit allowed. For example, assume the taxpayer is married filing jointly with AGI of $175,000 and a dependent student who would otherwise qualify the taxpayer for a $2,500 AOC if there was no phaseout. Since AGI of $175,000 lies three-quarters of the way into the phaseout range (of $160,000 to $180,000), three-quarters (i.e., $1,875) of the otherwise allowable credit is phased out and only $625 of the AOC is allowed.

For 2015, if the taxpayer files single or head of household, the LLC starts phasing out if AGI is above $55,000, and disappears if AGI is $65,000 or above. If the taxpayer is married and filing a joint income tax return, the LLC starts phasing out if AGI is above $110,000, and disappears if AGI is $130,000 or above.

Assume a taxpayer who is married filing jointly has two student dependents attending college full-time. The taxpayer can take one of the two credits for each student but cannot take both credits for the same student in the same year. So which higher education tax credit should the taxpayer claim for each student? If the student qualifies the taxpayer for the AOC, the taxpayer should always take it because it saves more tax than the LLC. However, the AOC is only available during the first 4 calendar years of postsecondary education for each student. The credit is 100 percent of the first $2,000 of tuition and required fees and course materials, plus 25 percent of the next $2,000, for a maximum $2,500 tax credit per student, per year. To qualify, the student must be enrolled at least half-time or more for at least one academic period during the calendar year. Assuming both students qualify for the AOC and qualifying expenses are at least $4,000 for each of them, the taxpayer can claim $5,000 of AOCs for the year. Assume instead that one of the two students is an undergraduate at a university and is in his or her first 4 years of higher education and the other student is in a graduate program at a university. The former student qualifies the taxpayer for a $2,500 AOC, and the latter student qualifies the taxpayer for an LLC, based on tuition and required fees.

For the taxpayer to claim the LLC, the student does not need to be enrolled at least half-time and there is no limitation on the number of years the student qualifies the taxpayer for this credit. This means that tuition and required fees paid to attend college part-time are eligible for the LLC but not the AOC. However, the LLC is less generous than the AOC; the LLC is 20 percent of up to a maximum of $10,000 in combined tuition and fees, regardless of the number of students qualifying for the LLC. Now assume that the two university students in the prior example are both beyond their first 4 calendar years of higher education. The maximum LLC the taxpayer can claim for the year is only $2,000.

Try to Claim Deduction If Not Eligible for Credit

Through 2014, a deduction was available for tuition and required fees. As this article is being written,

Congress is considering extending the deduction either through 2016 (the Senate) or permanently (the House). This is an above-the-line deduction, not an itemized deduction, so it reduces the taxpayer's AGI and income tax. If a taxpayer claims this deduction, he or she cannot take any education credit (discussed above) for the same student for the same year and vice versa.

The maximum tuition and fees deduction for a taxpayer is $4,000. This maximum deduction can be reduced depending on the taxpayer's AGI and filing status. Specifically, if filing status is single or head of household, the maximum deduction is allowed only if AGI (before this deduction and the U.S. production activities deduction [IRC Sec. 222(b)(2)(C)]) is $65,000 or less. The maximum deduction is reduced to $2,000 if AGI is in the range of $65,001 to $80,000. Above $80,000, the deduction is $0. If filing status is married filing jointly, the maximum deduction is allowed only if AGI is $130,000 or less. The maximum deduction is reduced to $2,000 if AGI is in the range of $130,001 to $160,000. Above $160,000, the deduction is $0.

Assume the Congress (and President Obama) extend the tuition and fees deduction into 2015. If the student's tuition and required fees are eligible for the AOC, it should be taken instead of the LLC or tuition and fees deduction because it results in the most tax savings. On the other hand, if the student's tuition and required fees are not eligible for the AOC (because student is beyond first 4 calendar years of higher education) or the LLC (because AGI is too high), the tuition and fees deduction should be taken. Specifically, if AGI is above the end of the phaseout range for the LLC (i.e., $65,000) but $80,000 or less if single or head of household, or if AGI is above $130,000 but $160,000 or less for married couples filing jointly, the taxpayer's AGI is too high to claim any LLC, the tuition and fees deduction should be taken. Another possibility is that qualified higher education expenses are not eligible for the AOC and the taxpayer's AGI is in the phaseout range for the LLC (i.e., between $55,000 and $65,000 if filing single or head of household or between $110,000 and $130,000 if married and filing jointly). The taxpayer's tax return should be completed once with the tuition and fees deduction and once with the partially phased-out LLC and the taxpayer should choose the option that results in lower tax. The last possibility is that qualified higher education expenses are not eligible for the AOC but are eligible for either the LLC (without any phaseout because AGI is not too high) or the tuition and fees deduction. Generally, the taxpayer should choose the LLC instead of the deduction because the former can save up to $2,000 of tax whereas the latter can only save the deduction amount (maximum of $4,000) multiplied by the taxpayer's marginal federal income tax rate. Typically, the tax savings of the former will be greater than the latter. To verify this, the taxpayer's tax return should be completed once with the tuition and fees deduction and once with the LLC and the taxpayer should choose the option that results in lower tax. Table 1 summarizes the federal tax benefits for higher education tuition, fees, and required course materials.

Federal Tax Credits and 529 Plan Distributions

What about the ability to claim either one of the two federal tax credits or deduction for qualifying higher education expenses if such expenses are paid with 529 distributions? This has no negative impact on the amount of federal tax credits or deduction a taxpayer is eligible to claim.

Separately, it is possible that paying qualified higher education expenses with 529 distributions could lead to a very small increase in the income tax of the beneficiary of the 529 account's distributions. For the year, if the fraction of the student's adjusted qualified education expenses (AQEE) is less than the 529 account distributions for the student beneficiary's qualified higher education expenses, the beneficiary includes in income on his or her tax return an amount equal to "one minus the fraction of AQEE divided by the 529 distributions and then multiplied by the

amount of the 529 distributions that is 'earnings.'" This will be illustrated shortly. The additional tax due to such income is generally either a very small amount or $0 because the beneficiary of the 529 distributions is pursuing higher education and typically does not have high taxable income and/or the portion of the 529 distribution that is earnings is relatively small.

Form 1099-Q is received by January 31 after the end of each year for distributions from a 529 account for the year. It contains the amount of gross distributions (box 1), split into the earnings portion (box 2) and the return of basis portion (box 3).

IRC Sec. 529(c)(3)(B)(v)(II) says to compute AQEE that the total amount of qualified higher education expenses for the taxable year shall be reduced by the amount of such expenses that were taken into account in determining the credit allowed to the taxpayer. What this tax law is saying is that the taxpayer can claim a higher education tax credit even if the money was distributed from a 529 plan, and

TABLE 1
Overview of 2015 Federal Tax Benefits for Higher Education*

Federal Tax Break	American Opportunity Credit	Lifetime Learning Credit	Tuition and Fees Deduction
Maximum credit or deduction	Up to $2,500 per eligible student	Up to $2,000 credit per tax return	Up to $4,000 deduction per tax return
Beginning of phaseout range if AGI is greater than:	$160,000 if married filing jointly (MFJ); $80,000 if single or head of household (HoH)	$110,000 if MFJ; $55,000 if single or HoH[a]	$130,000 if MFJ; $65,000 if single or HoH
No tax benefit if AGI is:	≥ $180,000 if MFJ; ≥ $90,000 if single or HoH	≥ $130,000 if MFJ; ≥ $65,000 if single or HoH[a]	> $160,000 if MFJ; > $80,000 if single or HoH
Number of years credit or deduction is available	Only for 4 tax years per eligible student	Unlimited number of tax years	Unlimited number of tax years
Number of courses	At least half-time for at least one academic period	One or more courses	One or more courses
Qualified expenses[b]	Tuition, required fees, and required course materials	Tuition and required fees	Tuition and required fees
Recommendation	If eligible, take this credit instead of either of the other two	If not eligible for AOC and eligible for maximum LLC, take this credit[c]	If not eligible for AOC or LLC, take this deduction if eligible[c]

*Note: Parts of Table 1 are adapted from IRS Publication 970.
[a] Adjusted for inflation annually.
[b] Qualified education expenses paid in 2015 for an academic period that begins in the first 3 months of 2016 can only be used in determining an education tax break for 2015.
[c] If taxpayer not eligible for the AOC and eligible for the LLC but not the maximum amount, compare tax savings from the LLC and tuition deduction and claim the one with the highest tax savings.

that amount used to claim the credit just reduces the amount of qualified expenses used to determine if any of the 529 distributions are taxable income to the beneficiary. Typically, none of the annual 529 distributions is income because qualified expenses for 529 distribution purposes are broader than qualified expenses for the higher education tax credits. Room and board, for example, can be paid out of a 529 plan tax free as long as the student beneficiary pursuing a higher education is enrolled at least half-time. Even if the student lives at home, there is an allowance for room and board costs, so 529 distributions can be used for such costs. Next, the above tax rules will be applied to a few examples.

Examples

Assume a married couple that files jointly with AGI below $160,000 has a child whom they can claim as a dependent that lives at home and attends a local university full-time as an undergraduate and is in his or her first 4 years of higher education. Assume the child attended the university in both the spring and fall semesters and took the summer off. Also assume the child does not receive any scholarships and that tuition and required fees, books, and supplies total $12,000 for the year—all of which is paid for out of 529 account distributions where one parent is the account's owner and the child is the beneficiary. The first $4,000 of tuition is used to figure the parent's AOC of $2,500, the maximum allowable amount. The next issue is whether the child has to report any income on his or her tax return. This is the case only if 529 distributions exceed AQEE for the year. The latter amount is reduced by the $4,000 tuition used to claim the AOC for the year. However, the latter amount is increased by more than $4,000 for the year due to the room and board allowance. For the year, the 529 distributions ($12,000) do not exceed the AQEE (i.e., $12,000 – $4,000 + room and board allowance, which is greater than $4,000), so none of the earnings on the 529 distributions is income to the beneficiary.

Next, assume the same facts except that the child lives in a dorm at the university and room and board costs $9,000 for the year, all of which is paid for out of 529 account distributions. Also assume that the Form 1099-Q shows that of the $21,000 of gross distributions for the year from the 529 plan, $1,000 was earnings and $20,000 was a return of basis. In this case, 529 account distributions ($21,000) exceed AQEE (i.e., $17,000 = $21,000 qualified expenses for the year minus $4,000 tuition that qualified for AOC), and the child who is the 529 account beneficiary, not the parents, will have to include a portion of the earnings on his or her income tax return.[3] Specifically, $1,000 of earnings multiplied by the fraction of $17,000 divided by $21,000 (of 529 distributions) equals $809, which is tax-free earnings, but the other $191 of earnings is taxable income on the child's income tax return.[4]

Finally, assume the same facts in the last paragraph except that the student is in his or her fifth year of higher education and the parents can no longer claim the AOC, but instead claim the LLC. Also assume that the parents have AGI below $110,000 so that none of the LLC is phased out. Also assume that the $12,000 paid is broken down between tuition and required fees of $10,300 and required books and supplies of $1,700. On their tax return, the parents claim the maximum LLC of $2,000 on the first $10,000 of tuition and required fees. This changes the amount of 529 earnings the child reports as taxable income. Now, AQEE are $11,000 (i.e., 21,000 qualified expenses for the year minus $10,000 tuition and required fees that qualified for the LLC). The earnings portion of the 529 account distributions, $1,000, multiplied by the fraction of $11,000 (AQEE) divided by $21,000 (of 529 distributions) equals $524, which is tax-free earnings, but the other $476 of earnings is taxable income on the child's tax return.[5] Assuming the child has a 10 percent tax rate, the $48 of tax the child pays is much lower than the $2,000 tax credit the parents receive.[6]

Conclusion

Many taxpayers have AGI that is too high to claim any federal tax breaks for higher education expenses. For taxpayers whose AGI is not too high, it is a common misperception that to claim a federal tax credit (or a tuition and fees deduction) for qualified higher education expenses such expenses cannot be paid from 529 account distributions. This leads to the faulty advice given to some clients to not pay all qualified higher education expenses out of a beneficiary's 529 account(s). This article explains that even if tuition and required fees, books, and supplies and room and board are all paid out of 529 accounts, the federal tax credit (or federal tax deduction) is not impacted and, at worst, the beneficiary of the 529 account distributions might have to pay a very small amount of income tax. ■

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(1) Andrea Coombes, "The Tax-Smart Way to Draw '529' Funds," February 8, 2015, *The Wall Street Journal;* accessed at http://www.wsj.com/articles/the-tax-smart-way-to-withdraw-529-funds-1423454496

(2) Under federal income tax law, modified AGI (MAGI) is used instead of AGI. However, for the federal education tax credits, AGI and MAGI are the same amounts unless the taxpayer is a U.S. citizen or resident living abroad or a resident of a U.S. possession or Puerto Rico [IRC Sec. 25A(d)(3)]. Throughout this article, it is assumed that the taxpayer lives in the United States.

(3) Although normally there is a 10 percent penalty tax on excess 529 distributions, the penalty does not apply to any distribution which is includible in gross income but used for qualified higher education expenses. The 10 percent penalty tax thus does not apply to either this example or the next example.

(4) Given the facts in this example, the only way to avoid income would be if the 529 distributions were $4,000 lower. The tradeoff thus is whether to pay $4,000 of cash for tuition and take 529 distributions of $17,000 (i.e., $4,000 less), which results in $0 income to the beneficiary, or to make no changes to the facts but contribute the $4,000 that was not paid for tuition into the 529 account. To make the best decision, the financial service professional should compare the state tax savings, if any, and the expected future tax-free growth of the 529 account contribution (of $4,000) to the amount of tax paid by the beneficiary on the income (of only $191). This assumes the taxpayer does not already have 529 savings exceeding expected future qualified higher education expenses of the beneficiary (i.e., an additional 529 account contribution is a worthwhile idea).

(5) A Coverdell Education Savings Account (ESA) is another potential source, along with 529 accounts, for paying qualified higher education expenses. However, the maximum allowed annual contribution to a beneficiary's Coverdell ESA is only $2,000, and contributions are not allowed after the beneficiary reaches age 18. Assume the combination of distributions from a 529 account and a Coverdell ESA for a year exceeds AQEE. Assuming that both the 529 account and Coverdell ESA have values higher than the contributions, a portion of the earnings distributed from both accounts will be income on the beneficiary's income tax return.

(6) Assume the same facts in these examples except that the beneficiary of the 529 account is one of the spouses and instead of the child attending a university it is the spouse who is the 529 account beneficiary attending a university. The income, thus, goes on the parents' tax return. Specifically, $191 of earnings is income on the parents' tax return in the second example and $476 is income in this last example. In either example, multiplying the income by the parents' tax rate (not given) will cause a small offset to the tax credit claimed on the parents' tax return.